

Islamic Financial Engineering : Comparative Study Agreements in Islamic Capital Market in Malaysia and Indonesia

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Abstract

Objective –The objective of this paper is to provide a discussion Islamic Financial Engineering which practice between Indonesian Capital Market and Malaysian capital market. This paper also investigate whether regulator could effectively take a role in materializing demands for Islamic securities and whether regulator declaration is more convincing than *sharia* compliance declaration between IDX and KLSE.

Methods - We use descriptive analytic and literature study to see the background, market response caused by regulatory for Islamic Financial Engineering. We also analyze Islamic capital market regulatory from middle east countries.

Results - We find that Islamic Capital Market in KLSE (Malaysian Capital Market) more higher growth than IDX (Indonesia Capital Market) because of Islamic Capital Regulatory in KLSE much easier to improve Islamic Financial Engineering from conventional schemes.

Conclusion - This finding could explain why Islamic Capital Market in KLSE is still growing rapidly and IDX will adjust their Islamic Capital Market Regulatory to compete with regional Islamic Capital Market.

Keywords : Islamic Financial Engineering, Risk, Return, Derivative, Hedging, Option, Forward, Hybrid contract

Abstrak

Tujuan – Tujuan dari paper ini adalah meneliti praktik rekayasa keuangan Islam khususnya dalam Pasar Modal Malaysia dan Pasar Modal Indonesia. Paper ini mengeksplorasi peran pemerintah sebagai regulator dalam memfasilitasi peraturan yang digunakan dalam Bursa Efek Indonesia (IDX) dan Kuala Lumpur Stock Exchange (KLSE).

Metode – Metode penelitian yang dipakai adalah analisis deskriptif tentang kebijakan regulator dan literature keilmuan untuk melihat latar belakang, respon pasar terhadap peraturan dalam rekayasa keuangan Islam. Peneliti juga menganalisis kebijakan rekayasa keuangan Islam dalam pasar modal di Timur tengah

Hasil – Pasar Modal Syariah di Malaysia (KLSE) lebih atraktif dan inovatif dalam penerapan peraturan dalam rekayasa keuangan Islam dibandingkan dengan Pasar Modal Syariah di Indonesia (IDX) karena kapitalisasi pasar yang sudah besar dan kemudahan dalam improvisasi produk pasar modal syariah di pasar.

Kesimpulan – Hasil penelitian ini menjelaskan bahwa Pasar Modal Syariah di Malaysia terus berkembang sedangkan Pasar Modal Syariah di Indonesia masih terus menyesuaikan dengan perkembangan pasar dan terus berkompetisi dalam pasar modal syariah regional

Kata Kunci : Islamic Financial Engineering, Risk, Return, Derivative, Hedging, Option, Forward, Hybrid contract

1. Introduction

In 2012, Malaysia dominated the Global Islamic Bond or Global Sukuk, and according to Standard & Poor's the domination will continue in 2013 reaching up to 74% of sales of global islamic bond. Consequently, Malaysia become the leader on the selling of global sukuk compared to Middle East and Asia-Pacific countries. Whereas Indonesia started to see the opportunity on selling the global sukuk for funding domestic projects after reinforced with the issuance of fatwa National Sharia Council or *Dewan Syariah Nasional* No: No: 69/DSN-MUI/VI/2008 About Sharia State Securities (Surat Berharga Syariah Negara or SBSN) and the issuance of global sukuk by the government on 2008 for 4.7 trillion rupiahs.

In the sharia banking industry, Malaysia has accumulated total asset for US\$ 86.4 billion, putting Malaysia below Iran which recorded Islamic banking's total asset of US\$ 614.1 billion. Meanwhile, asset of sharia banking in Indonesia amounting US\$ 10.8 billion is only one-eight of Malaysia's Islamic banking asset. But it is still bigger than Islamic Bank in Pakistan which is only US\$ 7.3 billion. In terms of market share, Sharia banking in Malaysia has the biggest market share of up to 19.98% in 2012, while Indonesia has only 4.58% in 2012 compared to conventional banking. Pakistan, which is smaller in the asset than Indonesia, has the bigger market share, and has reached 8.6% in 2012 (Ascarya, 2013).

The evidence suggests that innovation on Islamic banking product in Indonesia is still lacking and far behind. Products are still monotonous and stiff or not dynamic. Based on the study of Islamic banking practitioners of Kuwaity Investment Company, Baljeet Kaur Grewal (2007), Indonesia occupied the third cluster on the product innovation and market development of Islamic banks. While the fourth cluster as the highest cluster is Malaysia, Bahrain, the United Arab Emirates. The fourth's cluster is the country with the most innovative and varied in product development. While Indonesia, Brunei Darussalam,

North Africa, Turkey, and Qatar is under the fourth cluster's countries. Thus, these countries still less than the fourth cluster.

According to the study of Baljeet from Kuwait, countries Islamic banks developers divided into four clusters. The fourth cluster (the highest), is Malaysia, Kuwait, Bahrain and the United Arab Emirates; third cluster consist of Indonesia, Brunei, North Africa, Turkey and Qatar. Second cluster, Germany, USA, Singapore, Lebanese and Syrians, while the lowest cluster still wait are China, India, Hong Kong and Azerbaijan. (Agustianto, 2010)

Development of Islamic banking and finance industry in Malaysia was began with the enactment of the Islamic Banking Act 1983 and then followed with Islamic Insurance Act 1984 and SPTF guideline (Banking Scheme Without Profit or Skim Perbankan Tanpa Faedah) 1993. The development of Islamic banking and finance in Indonesia began with the establishment of Bank Muamalat Indonesia in 1992 and followed by the Islamic banking law in 2008, while the Act on Islamic insurance and Islamic capital market has not become a law. While the development of the Islamic capital market (ICM) in Malaysia evolved along with the industry of Islamic banking and Islamic insurance, because the capital market is essentially a financial institution to finance the investment from surplus capital industry to be invested.

The establishment of the Islamic capital market in Malaysia aims to run parallel with the conventional capital markets, as an alternative on financial and investment institutions, mobilize sharia fund of Islamic business institutions, facilitate investors and Islamic fund management, Islamic banking complementary institutions in strengthening the Islamic financial system as well as the last is to make Malaysia a hub of investment banking and Islamic finance globally (Minai, 2013). In addition to infrastructure and

regulation of the government of Malaysia, Malaysia's banking and finance industry known for its creativity and innovation of financial products to attract global investment.

Development of Malaysian Islamic financial investment products are created without any conflict to compliance on Islamic beliefs as well as investment products to be free from the element of interest, gambling and gharar *(the activities such as the basis for the creation of instruments and the trading of such instruments in the ICM, are carried out in ways that do not conflict with the conscience of Muslims and the religion of Islam and represents assertion of religious law so that the market is free from activities prohibited by Islam such as usury, gambling and gharar)*. (Minai,2013). The development of Islamic Financial Engineering need to be examined as it relates to the contract/ transaction which is allowed and forbidden in Islamic economy and its relationship to the managed fund large and rational Muslim investors, which is looking for an investment instrument that brings a high return.

Terminology 'financial engineering' has several connotations and different meaning in each context of use (Marshall and Bansal, 1992). In conventional finance, 'financial engineering' associated with derivatives, while the concept of Islamic finance is viewed from the agreement or 'aqd side. In accordance with Finnerty (1988,1994) Merton defines that financial engineering is the design, development and implementation of innovative financial instruments, process and formulation of creative solutions in finance. The purpose of financial engineering are transaction costs and get the maximum return. (Merton, 1992)

Innovation is essentially unpredictable, as many of the variables that influence the acceptance or rejection of an innovation. The use of tools/ equipment and techniques are critical for innovation and creativity. Financial engineering can be described as the principles and strategies for the development of innovative financial solutions. Financial

engineering emphasize on tools and techniques to develop creative and innovative instruments products. (Mason, 1995)

There are financial principles in Islam for the development of Islamic financial products. Principles and strategies for the development of Islamic financial products is dependent on the instrument or contract/ agreement (al-Suwailem, 2006). Emphasis on value-added financial innovation is the solution that provides the satisfaction of the needs that were not initially possible to provide maximum efficiency and return. And financial engineering is not merely a matter of mathematical models or legal document but rather based on economic development and managerial flexibility. (Merton, 1992)

Drucker (1999) stated that the financial institutions of more than 30 years did not have any major innovation other than providing services to customers, trading in customer accounts as well as entangled in a 'zero sum game'. Innovations developed over the last three decades is derivative.

In the perspective of Islamic finance there are four (4) principles of financial engineering which is grouped into goals and methodology. Goal principle is the principle of balance and the principle of integration, while methodology principle is the acceptability of the principle (principle of acceptability) and the consistency principle (principle of consistency) (Suwailem al, 2006).

The purpose of this study is to analyze the differences/ comparisons of agreement or *aqd* creativity in the development of Islamic financial products (Islamic Financial Engineering) in Malaysia and financial products and Islamic capital market in Indonesia.

2. Methodology

The methodology of this study applies both literature study and descriptive analysis as well as qualitative data. The first stage of this method compared not only the development of Islamic financial institution in Malaysia and Indonesia, but also in global.

2.1. Literature review comparison

2.1.1. Development of the Islamic capital market in Malaysia

Debt securities and *Sukuk* market in Malaysia are supervised by the Securities Commission (SC) and Bank Negara Malaysia. Role of Securities Commission (SC) is regulating debt securities and *sukuk* by issuing *Malaysian Debt Securities and Sukuk market (a guide for issuers and investors)*. In addition, SC also monitor trading in the secondary market and conduct inspections to banks who served as principal dealer with Bank Negara Malaysia (BNM). Bank Negara Malaysia also plays a role in supporting the debt securities and *Sukuk* market through its involvement in infrastructure development, framework of the administrative promotion on foreign exchange facility for issuers or emitent and foreign investors in the Malaysian market.

Based on information obtained from Bank Negara Malaysia, there are three types of issuers of Islamic bond (*sukuk*) which is the government (government / GII), SOE (Quasi Khazanah Benchmark Government Bond), and Company (Corporate Bond / Islamic Private Debt Securities (IPDS)). In addition, the type of Islamic bond issuance are used in:

- *Debt based (Malaysian GII and Khazanah bonds)*
- *Asset based (Using SPV)*
- *Equity based*

Instruments that can be traded in the Malaysian bond market consists of conventional and Islamic securities namely:

- *Government Securities*
- *Bank Negara Papers*
- *Cagamas Papers*
- *Private Debt Securities (PDS)*

Furthermore, in order to promote the activities of the secondary market, to increase liquidity and help investors of debt securities and *sukuk* market to earn the highest profit, Malaysia design a variety of activities such as *repos*, *sell and buy-back*, *Institutional Securities Custodian Programme*, *Securities Borrowing and Lending*, *When-issued Trading and short selling* (regulated). Besides, *SC Shariah Advisory Council* has approved the principle of *bai' dayn*, i.e debt trading, as one of the concepts in the development of Islamic capital market instruments. Activity of Secondary bond market and *sukuk* is done through an integrated banking institution or licensed by the SC, by appointing good banking institution as the Principal Dealer (PD) or The Islamic Principal Dealer (i - PD) . Those happened based on certain criteria, including their ability to handle large volumes of transactions measured in primary auctions, secondary market trading volume and their overall risk. Furthermore, in order to ensure the performance of PD and i-PD , BNM assesses them every 6 months.

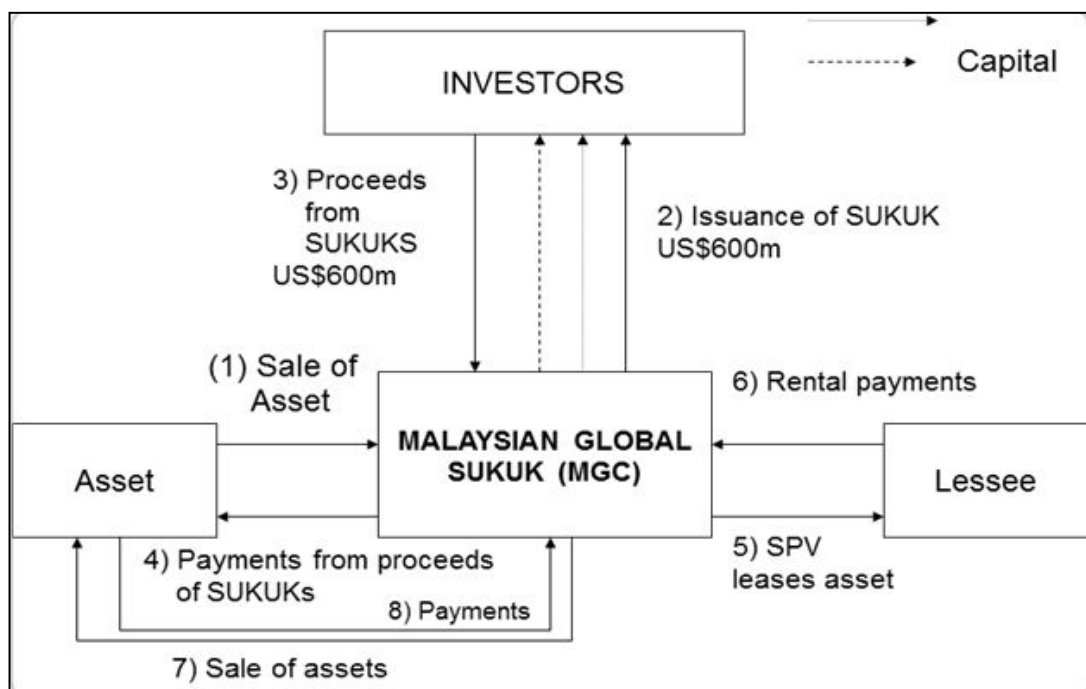


Figure 1. Mechanism on Malaysia's Global *Sukuk* Offerings

2.1.2. The development of Islamic Capital Market in Indonesia

In most countries the majority of trading of bonds and *sukuk* was traded outside the exchange market though it has been providing infrastructure that allows the trading of bonds and *sukuk* carried in stock. Countries in the sample studied that have infrastructure to trade on the exchange but trade is still largely done outside the exchange are Indonesia, Japan, Hongkong, Malaysia, and South Korea. While some countries such as Saudi Arabia and Qatar recently introduced trading in bonds and *sukuk* market in 2009 and September 2012. Furthermore, the description below will be used to analyze trading system in the secondary market of corporate *sukuk* in Indonesia based on the amount of trading activity which is the discussion on trade over the counter and on exchanges.

2.1.2.1. Over The Counter (OTC) Trade

Existence of trading debt securities and/ or corporate *sukuk* outside the stock exchange in Indonesia has been stipulated in Bapepam - LK No. III.A.10. The regulation stated that the Securities Exchange is prohibited to make regulations that prohibit or hinder the Issuer or the Securities Administration Bureau/ *Biro Administrasi Efek* (BAE) to register securities acquired through transactions outside the stock exchange or securities requires that the transfer should be based on the Exchange Transaction. However, the Stock Exchange may prohibit its members to carry out transactions outside the exchange market of Securities listed on the Stock Exchange. Although based on the regulation of Bapepam-LK, Stock Exchange has the authority to place restrictions for AB to conduct transactions outside the stock exchange on which securities listed on the Exchange, current restrictions on transactions outside the stock exchange by the Indonesia Stock Exchange is only applicable to equity securities listed on the Exchange and applies limited to exchange members as stipulated in the regulations No. II - A about Equity Trading. No restriction on transaction of debt securities and corporate *sukuk*

outside the stock exchange, is one of the reasons why investors trade debt securities and *sukuk* outside the stock exchange.

In addition to regulatory considerations, there are several factors that are considered by investors to prefer *sukuk* trading outside exchanges compared with the exchange transaction. Factors - factors include:

- The parties have a clear understanding to the opponent's profile transactions;
- Avoiding transaction costs, namely by using PT KSEI institutions as providers of custodial services, the cost borne by the parties is only mutation fee per transaction;
- Determine price based on the agreement, i.e. the agreement of the parties can determine price according to the needs and wishes of the parties;
- The need to conduct transactions in a quite large amount/ volume (block sale)

However, in order to generally accommodate the importance of market, that is the establishment of a fair, efficient and ordered market, trading outside the stock exchange mechanism has several drawbacks: first, non-transparency in the transaction will result in uncertainty level of transaction price. As a result, investors are not validly having a reasonable benchmark price of *sukuk* for the next transaction. Second, transactions outside the exchange did not accommodate investors who did *sukuk* transactions in small amounts (retail). It is often felt by the retail *sukuk* holders when they want to sell it. The Bank as potential buyers often give a price levels with big difference from the fair market price. Therefore *sukuk* holders will only have two options, namely to sell *sukuk* below fair market price or *sukuk* held to maturity (held to maturity) to avoid losses. Third, with limited number of corporate *sukuk* currently available, the execution of transactions in OTC is not supporting the improvement of secondary market trading liquidity of corporate *sukuk*. Fourth, supervision by regulators against the transactions is more difficult than if the transaction is carried out through the stock exchange.

2.1.2.2. *Fair market value analysis of corporate sukuk*

Given that *sukuk* is an Islamic securities with particular characteristics, the fair market price valuation method of *sukuk* is different with the fair market price of debt securities. Currently there is no method to determine the fair market price valuation method specifically for *sukuk*, however this does not mean the fair market value assessment can not be done over the *sukuk*.

The existence of a fair market price valuation method that is not contrary to Islamic principles is an important requirement in improving secondary market liquidity of *sukuk* in Indonesia. One effort to do for assessment of *sukuk* is the adjustment to the existing fair market value assessment methods so it does not conflict with Islamic principles.

Fair market price valuation methodology used by the IBPA is not based on a particular type of effect, but based on the nature of the cash flows of these securities. Fair market price valuation of debt securities or *sukuk* current properties which is currently used today is using cash flow calculated based on the time the investor receives a good income from interest/ Ijarah fee/ profit sharing periodically before accepting the principal amount at the end of the period of validity of these securities. However, though *sukuk* and bonds have a "semblance" of the cash flows, there is a difference in character between the *sukuk* bonds that can lead to differences in methods of valuation fair market price.

IBPA inform some important things to consider in assessing the fair market value of corporate *sukuk* bonds compared . These things include as follows:

1. *Sukuk* is not a bond but it is the ownership of an underlying asset .

Despite having a common character in terms of cash flow, *sukuk* is fundamentally has different character with bonds in general. Issuance of *sukuk* shall be accompanied by underlying assets accompanying the money. Therefore it can be said that *sukuk* represents the ownership of an asset, while bonds are debt instruments affidavit. Because *sukuk* represents ownership of an asset, it should implicate the lower risk the investor *sukuk*

holders could get compared with the bondholders. The lower risk of *sukuk* than corporate bonds reflected in the lower yields of *sukuk* than bonds.

2. Corporate Sukuk issuance process in Indonesia is not Involving Special Purposes Vehicle (SPV)

Issuance mechanisms of corporate *sukuk* in Indonesia differed with the issuance of *sukuk* schemes in various countries. The difference lies in the need for some other entity that issued *sukuk* and in its bankruptcy remote character (not bankrupt). In other countries *sukuk* is not issued by a company as originator but performed by a specialized company which is a SPV. While the issuance of corporate *sukuk* in Indonesia immediately issued by the issuing company because there is no regulation that allows the issuance of corporate *sukuk* via SPV. Issuance of *sukuk* that uses SPV in Indonesia is solely done for state *sukuk* (global *sukuk*).

Implications of not using SPV in the issuance of corporate *sukuk* in Indonesia, from a business standpoint, would impact to the reduction in fees as issuers issues *sukuk*. Therefore, the issuance of corporate *sukuk* in Indonesia does not involve SPV, so there is no SPV cost component in the calculation of the fair market price.

3. Fees or Sharia Rewards in Corporate *Sukuk* Issuance

As one of Islamic products, issuance of corporate *sukuk* needs supervision on sharia aspect. It is important to maintain the characteristics of *sukuk* and prevent the arguments that corporate *sukuk* the same as bonds. Sharia fee is a fee for the provision of Sharia Expert Team in *sukuk* issuance process. Sharia experts is the person in charge to provide a conformity opinion on the principles of the Islamic Sharia to the sharia securities issued by the issuer. The Expert Team has to compile Islamic *sukuk* scheme, give advice on kind of assets that can be the underlying *sukuk*, and granting a proposal of rights and obligations of the parties (issuers and investors, represented by the trustee) in the trustee agreements.

In practice, fee paid by the issuer to Sharia Expert Team only once charged and are part of the corporate *sukuk* issuance costs. In addition, according to an underwriter in charge of the issuance of *sukuk* and *sukuk* issuers, the costs pent by the company for Sharia Expert Team is not a cost component which is quite significant in *sukuk* issuance costs. In addition, after a corporate *sukuk* issued, there is no cost to be incurred by the Issuer to the Sharia Expert Team for supervisory duties fully have been transferred to the *sukuk* trustee. Therefore, fee for Sharia expert team is only required once and accrued as the *sukuk* issuance costs, then there should be no sharia cost as cost component in the calculation of the fair market price of *sukuk*.

Basically these three components is a "superior factor" of corporate *sukuk*, which in turn can reduce costs in the process of calculating fair market value of corporate *sukuk* than corporate bonds.

2.1.2.3. Potential issuance of Retail Sukuk Corporate

One of the main factors that affect fewer liquidity in the secondary *sukuk* market is the lack of corporate *sukuk* issuance in Indonesia. Issuers that have long engaged in the Indonesian capital market does not use much on *sukuk* issuance as a source of its funding. This happens because the Issuer has been familiar with the bonds for long time so issuers are reluctant to issue *sukuk*, moreover, there are some additional requirements in the issuance of *sukuk*. However, basically corporate *sukuk* has a huge potential in Indonesia especially when it is offered for retail. Successful of the retail state *Sukuk* issuance provide enough evidence that majority of moslem in Indonesia are also potential investors of corporate *sukuk* in Indonesia.

The existence of retail investment products are very promising in Indonesia. Middle-class people who are currently developed rapidly in dire need of various products as their means of investment. Given the success of Retail State Sukuk, existence of retail

corporate *sukuk* also had chances in an effort to make the benefits of the Indonesian capital market becomes more attractive, namely:

a. Significant increase of investor in the capital market

Corporate retail *sukuk* issuance has the potential to increase new investors in the capital market. Additional potential investors is possible because investment on corporate retail *sukuk* is not too big, therefore many people dare to begin to try investing in securities in the capital market. Experience of novice investors in the retail *sukuk* will create a *snowball effect* in the future that will eventually bring people to the products in the capital market.

b. Expanding access of the middle-class people to capital market

An increasing number of the middle-class (middle income) people in Indonesia is a huge potential for investment in securities on the capital market. Involvement of banking institutions as selling agents of corporate retail *sukuk* will give closer access to the products of the middle-class in the capital market.

c. Balancing Deposits in banking institutions with capital market institutions

The more easily people buy securities in the capital markets, the more impact on society through increased investment in capital market products. The majority of people who currently keep their funds in banking institutions will begin to switch into the instruments in capital markets which have higher profit levels compared with banking products.

d. Great potential for the real sector as underlying corporate *sukuk*

Issuance of corporate retail *sukuk* in Indonesia has much potential given the large number of real assets that can be used as an underlying asset in the issuance of corporate *sukuk*. In addition, the issuance of corporate retail *sukuk* is expected to help the government to drive real sector in the country so as to further improve the national economy.

2.1.2.4. Characteristics of Corporate Sukuk Retail

Construction of retail *sukuk* schemes have no different from the existing corporate *sukuk* include delivering and disclosing information in the prospectus, the result of the securities grading and trustee contract, statements that the operations of the underlying *Sukuk* issuance is not contrary to Islamic principles.

3. Result

3.1. Malaysia Islamic Capital Market

In terms of structure, the role and purpose of Islamic Capital Market has no different from conventional capital markets. Issuers expect efficient and maximum capital while investors choose investment instruments in accordance with their financial needs. The most important creation basis for investment instruments and tradings in the Islamic capital market is not in the contrary with the beliefs and norms in Islam such as the elements of usury, gambling and gharar.

Islamic capital market is one of the components of the financial system in Malaysia and it plays a major role in economic growth. Islamic capital markets has a parallel function with the conventional capital markets and together with the Islamic banking system in running the Islamic finance market in Malaysia.

Securities Commission (SC) of Malaysia is responsible for the infrastructure that supports the operational of Islamic capital market in Malaysia including establishing Sharia Advisory Council (SAC) in 1996 which is responsible to oversee and provide advice to the development of Islamic economics and finance. Some investment products such as Sharia-compliant securities, *sukuk* Islamic unit trust, sharia index, warrants and CPO futures contract as a forum for Muslim investors in terms of investment.

Malaysia is a pioneer in terms of both investment banking and Islamic finance, this can be seen from the products launched by the Islamic capital market in Malaysia:

1. The first Islamic equity unit trust fund, Arab Malaysian Ittikal Tubes (1993)

2. The first full-fledged Islamic stock broking company, BIMB Securities Sdn. Bhd.. (1994)
3. The securities commission formed an Islamic Capital Market Unit roomates later evolved into a full-fledged department (1995).
4. The Shariah Advisory Council (SAC) was later established in 1996
5. Islamic capital market master plan which is formulated to make Malaysia a world center of Islamic capital market (2001)
6. The Malaysian Government sukuk, as the first global sukuk having 2 times oversubscribed (2002)
7. Tax incentives similar to conventional securities for securities of the Islamic capital market (2004).

Islamic capital market in Malaysia together with other exchanges in the world and consists of primary market and secondary market where stocks and bonds are traded. For Malaysian government securities consist of Government Investment Issues (GII) and the Malaysian Savings Bond (MSB) Islamic Principle.

GII is the alternative to government Islamic securities (Malaysian Government Securities) which was launched in 1983 with a Qardhul Hasan contract. While MSB was launched in 1999 with a contract of Bai 'al-Inah (buy-back arrangement).

3.1.1. Sharia Corporate securities

Sharia Corporate securities consists of Islamic Debt Securities (IDS) and the Islamic equity market. IDS was first launched for the Shell Group in 1990 with a contract of Bai 'Bithaman Ajil (BBA) with a value of U.S. \$ 125 million. While Islamic Equity market which reflecting Islamic stock index, Islamic fund managers, Islamic Stock Broking House and the Islamic Unit Trust.

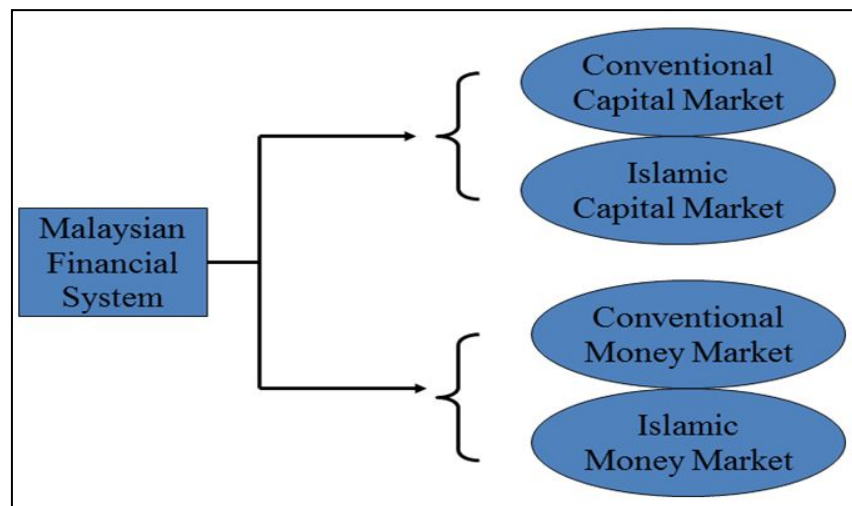


Figure 2. Malaysian Financial System

In addition there are several regulators in the Islamic capital market in Malaysia, namely;

1. The Securities Commission (SC) (www.sc.gov.my)
2. The Kuala Lumpur Stock Exchange (KLSE) (www.klse.com.my)
3. Bank Negara Malaysia (BNM) (www.bnm.gov.my)
4. The National Shariah Advisory Council (NSAC)

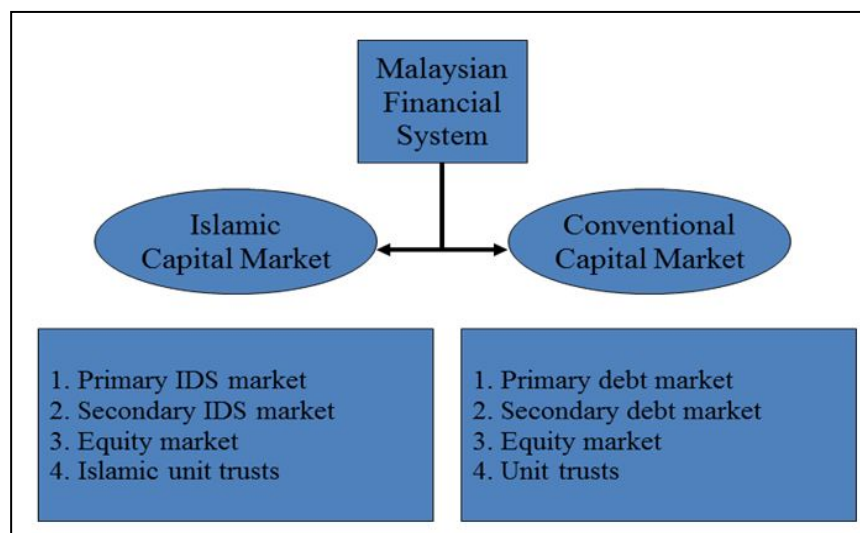


Figure 3. Malaysia Financial System



Figure 4. Islamic Capital Market

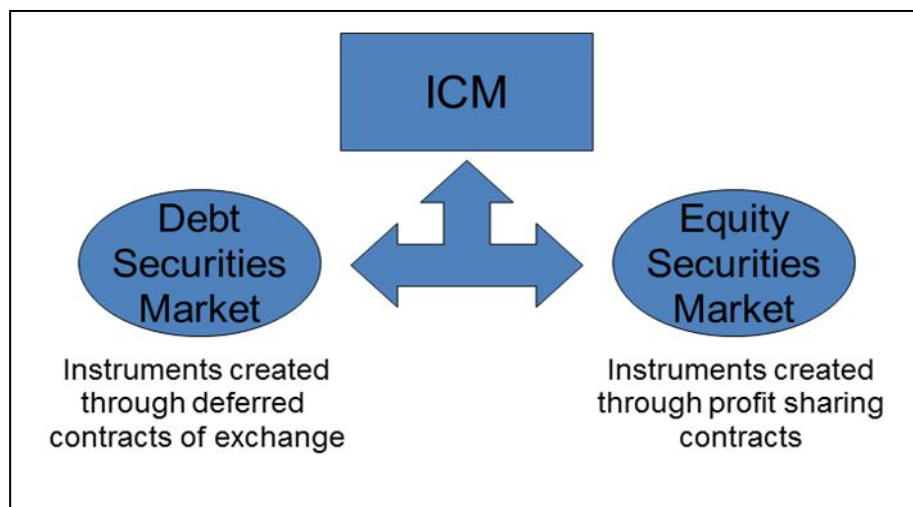


Figure 5. Islamic Capital Market Structure

While the products traded securities:

1. Government Bonds (eg Government Investment Certificate, GII, the concept of *qardhul hasan*)
2. Government Guaranteed Bonds (eg Khazanah Bonds, a zero coupon bond with the concept of *murabaha* and *bai 'al-dayn*)

3. Corporate Bonds (eg Sanadat Cagamas Bond, with the concept of *Al-Bai Bithaman Aji*)
4. 'Permissible' Stocks & Shares which are identical to financial engineering/product derivatives such as call warrants, TSR and asset securitization.

3.2. Indonesian Islamic Capital Market

Sukuk issued in Indonesia entirely using *ijara* and *mudharabah* contract. Based on AAOIFI Shariah standards stated that *sukuk* issued based on *ijara* and *mudaraba* contract are tradable. In the regulation number IX.A.13, it has been set out clearly that the structure of *sukuk ijara* and *mudaraba* can be traded in the secondary market where the funds from the public offering has been collected by the Issuer, and for *sukuk mudaraba* contract, the funds have been used in accordance with the plan to use the funds.

Existence of transactions in the stock exchange has been stipulated in Bapepam-LK No. III.A.10. These provisions stated that the Exchange must issue rules that specify the terms and conditions of the Exchange Transaction. For the implementation on Exchange securities trading, the Stock Exchange has adequate infrastructure to implement the transaction for both equity securities and debt securities and/ or corporate *sukuk*. In corporate *sukuk* trading, the Stock Exchange has been providing electronic trading system called FITS, PT KPEI in order to have clearing and EBOCS facilities, and PT KSEI has had CBEST platform for the implementation of the transaction settlement. However, unlike the trading of Equity Securities, the applicable provisions of the Stock Exchange is that there is no obligation for Member of Securities Exchange to transact debt and *Sukuk* listed on the Exchange, through the Exchange system.

Corporate *Sukuk* trading in Indonesia Stock Exchange or BEI has not been used by investors to trade corporate *sukuk*, and investors, to date, prefer to have transactions outside the stock exchange. The investors choice is reasonable, because transactions

outside the stock exchange is considered more comfortable to investors. However, the actual exchange transaction offers several advantages which is not obtained on over the counter. Some of the advantages include transparent trading mechanism, the failure of the transfer and payment of *sukuk* can be minimized due to the clearing and guarantee system, and the prices established from transactions in the regular market is the fair market price for the *sukuk*. In addition, the parties do not need to communicate with each other face to face to transact as transactions outside the stock because everything can be done electronically.

From the Sharia aspect, particularly transactions of equity securities in the stock exchange is in accordance with Islamic principles as stated in Fatwa No. 80/DSN-MUI / 2011 on the Application of Sharia Principle in Equity Trading Mechanisms in Regular Stock Exchange. Meanwhile, there are no DSN - MUI Fatwa stating Shariah permissibility for the transaction of corporate *sukuk* in the market yet. Nevertheless, the absence of DSN - MUI Fatwa related to corporate *sukuk* traded in the secondary market does not mean it is not in accordance with Islamic principles. It is based on the opinions of *Fiqh* scholars jurisprudence stating that the rule of *muamalah* is "*Al ashlu fil mua'malati al ibahah Hatta yadullu ad daliilu ala tahrimiha*" (the legal origin in muamalah affairs is allowed, unless there is a *daliil* that prohibit it). In accordance with this matter, given the corporate *sukuk* trading in the secondary market can be categorized as *muamalah* activities, so it is apply that *fiqh* rule for corporate *sukuk* is allowed in Sharia, until the corporate *sukuk* is prohibited by Sharia.

Implementation of trading with the auction system known as "*bai 'al-Musawamah*" as stated in the DSN-MUI Fatwa No. 80/DSN-MUI/III/2011. Furthermore, based on the Islamic principle on commercial transactions, *sukuk* transactions through the stock exchange does not conflict with Islamic principles because the conditions and pillars of trades have been met. This is showed by the parties for transaction on the basis of

compliance, the consent granted or *ijab qabul* by the system, or the goods and instruments that bought and sold namely the *sukuk* allowed by sharia, and free of manipulation and fraud.

Given that *sukuk* is an Islamic securities with particular characteristics therefore requiring a fair market price valuation method which is differ with fair market price valuation of debt securities. Currently there is no method for fair market price valuation specifically for *sukuk*, however this does not mean fair market price valuation can not be done over the *sukuk*.

The existence of a fair market price valuation method that does not conflict with Islamic principle is a significant need in improving liquidity of secondary market of *sukuk* in Indonesia. An effort to do for assessment of *sukuk* is the adjustment to the fair market value assessment methods existing so it does not conflict with Islamic principles.

Fair market price valuation methodology used by IBPA is not based on a particular type of securities, but based on the nature of the cash flows of these securities. Fair market price valuation of debt securities or *sukuk* applied currently using cash flow characteristic is calculated based on the time the investor receives an income from interest/ *Ijarah* fee/ profit sharing periodically before accepting the principal amount at the end of the period which is valid for the these securities. However, despite of *sukuk* and bonds which have "*similarities*" of the cash flows, there is a different character between *sukuk* and bonds that can lead to differences in methods of fair market price valuation.

IBPA informed some important things to consider in assessing the fair market value of corporate *sukuk* compare to bonds. These things include as follows:

1. *Sukuk* is not bonds but not the ownership of an underlying asset.
2. Issuance process of corporate *Sukuk* in Indonesia is not involving Special Purposes Vehicle (SPV)

3. Sharia fees or rewards in Corporate Sukuk Issuance

Corporate retail *sukuk* in Indonesia has much potential given the large number of real assets that can be used as an underlying asset in the issuance of corporate *sukuk*. Apart from that through the issuance of corporate retail *sukuk* is expected to help the government mobilizing the real sector in the country in order to continuously improving the economy nationally.

Table 1. Differences in the Islamic capital market instruments

<i>Features</i>	<i>Malaysian Sukuks</i>	<i>Indonesian Sukuks</i>	<i>Global Sukuks</i>
Issuer	Mostly Corporations	Government & Corporations	Mostly Governments
Certificates	Debt (IOU)	Trust (investments)	Trust (investments)
Contracts	<i>Bay' al-'inah</i> <i>Bay' al-Dayn</i>	Mudharabah & Ijarah	Sale & <i>Ijarah</i>
Capital & Income	Guaranteed by contracts	Government & contract	Government guaranteed
Yield	KLIBOR + margin Fixed	Fixed & Floating	LIBOR + margin Fixed and floating
Collateral	With collateral	With collateral	Without collaterals
Global Acceptance	Only in Malaysia	Only in Indonesia	Accepted in all countries
Juristic Differences	<i>Bay- al-'inah</i> and discounting <i>bay' al-dayn</i> acceptable to Shariah Supervisory Board of the Securities commission Malaysia	<i>Bay- al-'inah</i> and discounting <i>bay' al-dayn</i> not acceptable to Shariah Supervisory Board of the Islamic financial institutions in Indonesia	<i>Bay- al-'inah</i> and discounting <i>bay' al-dayn</i> not acceptable to Shariah Supervisory Board of the Islamic financial institutions in the Middle-East

4. Conclusion and Recommendation

4.1. Conclusion

- Malaysian Islamic financial markets, including government, regulatory bodies for stock exchanges, Sharia supervisory board are becoming more "bold" and "creative" in seeking to adjust to the concept of conventional finance.

- b. With these specific characteristics of *sukuk*, namely the availability of the underlying asset, the fair market price of *sukuk* should be better than the fair market price of the other debt, considering the lower risk factors faced compared to the securities that are faced by other nature of debts. Despite that, the fair market price valuation method of *sukuk* is not distinguished with the fair market price valuation method of bonds, and have not included underlying asset factor as one variable.
- c. Until now, in the secondary market, debt securities and/ or *sukuk* don't have market maker. This is likely caused by business factors and the lack of detailed rules that governing the market maker.
- d. Results of the analysis of the factors that are not directly related to market liquidity secondary *sukuk* is as follows:
 - the issuance of corporate *sukuk* in Indonesia both in terms of volume, tenor variation or type of contract is still limited
 - investors are lack of understanding regarding the trade of corporate *sukuk* in the secondary market
 - although some regulations have facilitated as the basis for the issuance of corporate retail *sukuk*, the Issuance of corporate *sukuk* is still not offer as a retail to the public but only limited to institutional investors or individual with a relatively large nominal value.
 - majority of those investing in *sukuk* are also investing in local institution such as Insurance Companies, Pension Funds and mutual funds that have a tendency to buy and hold them until maturity.

4.2. Recommendation

In order to improve the trade liquidity of corporate *sukuk* in Indonesia, it is necessary to include the following steps:

1. Availability of any means of information on debt securities and/or *sukuk* should be integrated, accurate, transparent and independent so it could provide details information on debt securities and/or *sukuk*, method of transactions, system and trading mechanism, value and price of transaction in the exchange or OTC. Therefore, the information can be use as the base to make decision regarding investment in *sukuk*.
2. The need for optimization of the fair market price valuation method of *sukuk* corporation by the LPHE by adding variables of the underlying assets to the fair market price valuation method to create a certain level of price that reflects the characteristic of *sukuk*.
3. The need to increase issuance of corporate *sukuk* by encouraging issuers and state-owned corporations (BUMN) to issue *sukuk* as a source financing.
4. The need to encourage those who are involve in the public offerings of corporate *sukuk*, namely securities issuance guarantor, issuers candidates, and professional and board support of the capital market to be synergize according to their portion in order to create corporate retail *sukuk* in Indonesia as a breakthrough in increasing the number of corporate *sukuk* and number of investors to the public and as well as the secondary market liquidity of corporate *sukuk*
5. The need for a policy breakthrough as a particular convenience for those who are willing to become a market maker such as less transaction cost, which allow the price spread risk to guarantee the market maker. This is expected to support the creation of a market maker in the secondary market of debt securities and/ or *sukuk*.
6. The need for socialization to increase knowledge and understanding of capital market stakeholders regarding the issuance of corporate *sukuk* and corporate retail *sukuk*.

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